The Interpretation of the Euro Crisis and the Reform of the Eurozone

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Introduction

As the European Union is nearing its 60th anniversary since the Treaty of Rome, it is in one of its most challenging times, hit hard by lack of growth and unemployment, while being increasingly contested by populist parties in all Member States. Many of its woes can be connected to the financial crisis and the national debt crisis, as well as the resulting policy responses. If Europe is to press forward as a long-term political project, it is essential that it starts to grow again organically, otherwise it risks to fracture internally even further. In this paper, I try to compare two readings of the financial crisis that fell on the Eurozone eight years ago, the institutional theory and the “varieties of capitalism” theory. After analyzing the crisis according to this two perspective, I frame the main policy answers that are being created, before finally suggesting a Eurozone framework that could tackle such systemic threat.

A multi-Faceted Crisis

The European financial crisis is the effect of weak governance response to a systemic external shock that originated elsewhere. However, given the structural inability of the Eurozone to act as one coordinated actor in countering the crisis, the recovering time has expanded dramatically; long after its originating place has mostly recovered.

Despite market integration success and the beginning of a pooling of monetary sovereignty, the gaps caused by fragmentation of economic governance have made so that such shock has reverberated unequally across the single market. The debt risk, initially assumed to be equal across all EU crisis, was then abruptly thought not to be so, causing unjustified sovereign debt panic and investors’ rush towards “safer” EU countries.

Following the revelation of the real size of the Greek national debt in 2010, market panic generated the notion of the existence of a “riskier” group of countries where crisis could hit next. Greece, Portugal, Italy, Ireland, and Spain were therefore lumped together in the same category, resulting in the unfortunate acronym of PIIGS. A distinction that reified a cleavage between purported hard-working Northern Europeans and slacking Southerners. (Caporaso & Kim, 2012: 770).

Such categorization together hide the reality of very different cases and very different crises that happened. Whereas reckless borrowing by the government for fueling consumption could hold true for the Greek case, Spain and Ireland are differing very significantly. Their difficulties arose instead from high volumes of investment capital crossing state lines, leading to credit-fueled booms in housing, tourism, and construction. In such cases, government debt even shrank prior to the debt crisis, and their issues were more connected to financial bubbles that had little to do with government spending and more to do with the uncontrolled free flow of capital (Caporaso & Kim, 2012: 770). However, it was avoided to frame their difficulties in such way, as free movement of capital is one of the four fundamental freedoms of the EU, part of the single European market.

The *crises* are thus a mix of very different structural reasons for each country, which have been triggered initially by the Greek debt discovery. It is partially irresponsible fiscal behavior; partially unregulated capital flows; and partially national wage increases untied to productivity improvements in their countries (Caporaso & Kim, 2012: 782).

Since the EMU lacked unified tools for tackling decisively these newfound systemic fears, cooperation and the will to sacrifice for the common good lacked at a crucial moment, adding and extending the initial problem. The lack of democratic and political space for designing new economic courses at a central level have compounded the effects of the economic crisis once it set in. As a result, the Eurozone is still deep in it, mudding through without yet a coordinated real answer to its economic governance, especially when redistributive policies should be involved. Two different interpretations attribute the crisis either to institutional failure or to a clash between different varieties of capitalism embodied in the different Member States. A brief assessment of both is due in order to assess future solutions to it.

An Institutional Crisis?

Even since its designing phase the Euro has been lacking in several aspects. Whereas currencies are among the most powerful tools a state can tinker with, they are not isolated in a void. In order to function properly, currencies are part of a larger set comprising both independent and political institutions, policies, fiscal capacities, and flexible fine-tuning space that are held by the "owner" of the market, i.e. states, thanks to

their political legitimacy of representing their citizens. As the single European market mimics the function of a state's internal market, the setting up of the Eurozone mimicked some of those instruments, while deliberately avoiding touching their other complementary aspects, as not enough consensus was reached by Member states for properly implementing them.

It could be argued that a ceiling glass was reached on the powers that states were open to share without worrying of losing their manoeuvring space on sensible issues especially from an electoral point of view, such as redistribution, economic policy, welfare states, and foreign and security policy. Given the difficult balance between their reluctance to cede additional sovereignty and the need to produce policies for making the single currency work, they set up an integrative model based on voluntary coordination between Member state governments, which raised the intergovernmental outlook of the future Eurozone and shielded them from real oversight from the European Parliament and the European Court of Justice (Fabbrini, 2015: 49).

At the end of the whole process, only the minimum common denominator was agreed on as binding measures: rigid and fixed macroeconomic parameters, a ban on state bailouts, and a single supranational currency regulated by a Central European Bank with a rigid focus on price control.

Even the latest iteration of the Maastricht Treaty, the Lisbon Treaty, has maintained the same unbalanced design of the EMU: monetary policy's centralization and economic policy's decentralization (Fabbrini, 2015: 45). Even the body most directly involved in coordinating governance, the Euro Group, embodied a specific approach to policy-making defined as "informal governance", whose limited scope is confirmed in the negotiated declaration before the Brexit referendum (European Council, 2016a: 7).

The final product was thus high on expectations but definitely low on steering power.

Nevertheless, this structure led to a great deal of market integration between the future Eurozone countries, as financial markets started to be increasingly linked with each other, as it was believed that the superstructure could be as reliable as a traditional state market. In short, at the turn of the millennium, Europe was highly integrated in both trade and financial services. These two modes of integration served as

means for transmitting international disturbances and benefits (Caporaso and Kim, 2012: 778). When the Greek crisis struck, it was impossible for most actors involved in the system to avoid deep repercussions.

It is fair to assess that the Maastricht recipe would lead quasi-structurally to disastrous immobility when only swift tough action could avoid a propagation of economic instability. When markets realized the Eurozone did not offer major safeguards and was not going to adopt them, panic ensued as it became acknowledged that also Spain, Italy, Portugal and Ireland could become unstable. The rush out of those economies fueled additional troubles and credit crisis.

As it happened, the European recipe for getting out of the common crisis was a “real economy devaluation” through austerity measures that would have made the subject states more competitive (Krugman, 2011). A harsh policy that has not achieved its goals but has added a further level of suffering to already heavily hit economies.

Without a clear institution not depending on single countries or vetoes, democratically accountable, in charge of designing coordinated and powerful responses to external shocks, the Economic and Monetary Union of the EU behind the Euro was only waiting for a crisis to happen. Stuck on discussion about “no transfer unions”, ban on traditional ways of sustaining embattled governments, the global economic downturn unleashed its forces on the weaker shards of Europe, nearly breaking the European dream. The only plausible way forward seems to be more integration, but a fear of electoral backlash seems to make it impossible for the time being.

It could be argued that the intensification of the intergovernmental setting during a shared economic crisis, where each leader is perceived as either “giving out” to foreign requests or holding back against requests on national welfare is further driving the perception of a zero-sum economic game that is naturally pressing domestic audiences towards more and more conservative/nationalist positions. In this sense, the choice to retain decision making over “real money” and sensitive decision in the hands of the European Council is further driving a competitive rhetoric that is wedging unusual (at least in the recent history) suspicion and hostility between the European *demoi*. In turn, this is fueling xenophobia, Euroscepticism and constraining

the choices available to national leader to employ real redistributive/restructuring solutions with real firepower. The resulting lack of trust between constituencies is limiting the ability of creating supranational European policies that may pool and use common resources as a single entity, giving a strong message to markets. In short, it is hampering the ability to create a real common vision towards shared growth for overcoming the ongoing crisis, which would be needed in order to reassure consumers and investors that the Euro is a sound and irreversible creation that is here to stay.

A "Varieties of Capitalism" Crisis?

An interpretation of the Euro crisis, alternative to the institutional failure, is the "varieties of capitalism" crisis. As explained by Hall (2014), the economic structures in the EU are profoundly different and could be grouped around two loose macro-categories: a highly coordinated high-value economic group of northern countries (more oriented towards a supply-side and export-led economy) and a group of consumption-driven southern countries, where there is more sensitivity towards state incentives.

The second group was more reliant on policies that fueled production by increasing demand (for instance, through public service jobs) that in turn increased inflation and therefore had systemic devaluation of currencies in order to become competitive again in their export vis-à-vis other countries.

The first group had a higher deal of coordination between different parts of the economy, with wage control more devolved towards the periphery and a great policy attention towards price control and inflation as a way of staying competitive in the world market.

As these different economies combined in a single currency with focus on price stability, the southern economies were left with no recourse to devaluation, while northern countries gained currency dilution with weaker economies, thus becoming even more competitive in the export market, accumulating huge trade surpluses that were reinvested abroad in the Eurozone, creating bubbles that busted during the Euro crisis.

The main policy innovation of 2012 has been the Fiscal Compact Treaty, formally the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. This intergovernmental treaty reiterates once again the obsession with "balanced" national budgets and imposes on participating governments to

reduce their debt-to-GDP ratio annually. During a deep recession, this intergovernmental setting led by "Euro hawks" was mainly concerned with avoiding unpayable debt (which would have affected bigger "more financially responsible" countries), while skipping altogether the link between fall in GDP through austerity measures and its further fueling of the issue.

Indeed, the Fiscal Compact has strengthened the informal Euro Summit as the center of the governance system and transposed some elements of the treaty in EU law by the so-called Two Pack. Eventually, as the crisis went on, it became clear that financial consolidation was not enough to overcome the Euro crisis, a weaker Growth pact was inked (Fabbrini 2015: 57).

As said by Hall (2014: 1233), the most fundamental problem is not institutional design, but what is really driving the decision-making rationale in the intergovernmental settings: the conflicts of interest among the different Member States. A striking feature is that the policy responses since the inception of the crisis is that national governments have approached it strictly from the point of view of their short-term national interests, instead of tackling it according to a long-term perspective of the collective interests of the EU.

The strenuous resistance of the "hawkish" governments of Germany, the Netherlands and Finland to the Outright Monetary Transaction program of the European Central Bank is a clear evidence of this worrisome trend.

The inherent flaw of this approach is that it has delayed a successful way out from the growth crisis, hitting cyclically even those governments that have favored short-term political solutions for internal popularity reasons, slowly eroding their political capital with their constituencies as the prolonged crisis has increased the appeal of populist Eurosceptic parties.

Additionally, the current answer to the crisis concerning growth appears not to take into account the specificities of those economies that are not led by high-specialization exports and are more fueled by internal consumption, thus revealing a logic governed by a "north-centric" intergovernmental setting.

The current "growth strategy" focuses on two main branches: a commitment to balance budgets embedded in Member States' constitutions and with strict central coordination; and structural reforms that translates

into weakening the social protections for workers, privatizations and deregulation (Hall, 2014: 1234). While these strategies could be functioning without much pain in advanced industrial markets such in Germany or in Denmark, it is irrational to expect them to produce growth in job creation and GDP in "southern economies", where the deep cuts in spending are also alarmingly decreasing GDP, making the debt ratio explode while ravaging the local economies.

Institutions like the IMF have recognized that current southern European rates of unemployment are likely to improve in the near term only if austerity measures are relaxed in favor of some reflation. Additionally, they argue that fiscal contractions caused by spending reduction by the states cause a harmful multiplier in the real economy of 1.5 or more. Many economists of different schools of thought are now arguing that insufficient fiscal stimulus has been among the biggest failures of the post-crisis era. (The Economist, 2016).

The Way Forward

Given the duration of the crisis, it became clear that further cooperation was needed and finally the Council asked the EU for broader reform guidelines for reforming the EU. Banking union, budgetary union, economic union and a political union were envisaged as necessary for additional firepower.

The output received was a proposal for a "deepening" of the EMU governance, presented by the Commission in the format of a report co-authored by the so-called "Five Presidents" of the most significant EU bodies (the Commission, the European Council, the Eurogroup, the ECB and the European Parliament), titled "Completing Europe's Economic and Monetary Union" (EC, 2015).

The report plans two major integration phases and four major fronts: Economic Union, Financial Union, Fiscal Union and Political Union (that is, democratic oversight). The refrain repeated throughout the document is that this path should lead to "share the impact of shocks through risk-sharing within the EMU" (EC, 2015: 4).

Scholars have for many years regarded the current framework as the most advanced that it could be obtained given its legal constraints. They have often cited as blocking issues concepts such as "the substantive constitutional limitations on the scope of authority delegable to supranational level" and the lack of

“autonomous democratic and constitutional legitimacy to exercise [fiscal] power without some mechanism of oversight by strongly legitimated bodies residing elsewhere” (Lindseth, 2014).

Nevertheless, as France and Germany have signaled (with many caveats) of being willing to achieve further unification regarding the governing of the Eurozone, many of such complaints disappeared almost overnight. This showed that European affairs are still much a matter of political will, not legal hurdles.

The main policy drivers in the document are an additional drive for convergence, job creation, ownership of reform at national level, a strengthened Macroeconomic Imbalance Procedure, accountability over lack of action, single deposit insurance, Eurozone-wide fiscal stabilization function. At the end of the process, the report envisions the possibility of a shared-treasury with tax powers. This might be the most groundbreaking bit of information, even if it is barely addressed in a couple of paragraphs.

Tax powers would entail self-funding, which is usually the domain of states. Classic nation-states have the political legitimacy to have large transfer system based on taxation. The joint report still clearly states that “in a Monetary Union like EMU […] large scale fiscal transfer between members are not foreseen” (EC, 2015: 7). Even when preparing for a European Fund for Strategic Investments, the caveat is that “it should not lead to permanent transfers in one direction only” (EC, 2015: 15).

Without the concept of systemic solidarity, which is a way of compensating weaker economic areas from their economic losses to comparatively more powerful areas thanks to unbridled competition, any economic bloc is doomed to fail. First by compounding economic problems in the poorer regions and parts of societies, then by falling to political backlash from those that had most to lose from such unions. The growth of xenophobic and populist parties among sectors of the electorate that have lower competitive hedge against “foreigners” could be partially explained by this.

France has taken the most advanced position, maybe as a way to regain the lost lead in the EU. In a speech (BBC News, 2015), France’s President Hollande called for a Eurozone-wide treasury with taxing power and a Eurozone elective body taking decisions on such budget. Commissioner Moscovici retorted that the only Eurozone parliament is the European parliament (European Parliamentary News, 2015). The question

remains if a centralized Eurozone will be able to have real steering power. Whereas key states' cooperation remain essential for a functioning union, their narrow interests should not prevail over others.

If such a body is able to generate more growth-geared measures, necessary transfer compensations (while staying financially sustainable and legitimized by an elected body) and ultimately jobs in the most suffering regions of the Euro zone, it will gain popular legitimacy. Otherwise, we will have a functioning legal system that just does not deliver and that will disintegrate with the deepening of the next economic crisis.

Still, whereas institutions can ease many burdens from the single currency, it is not clear if they will have enough teeth to bite into the economic differences between northern and southern economies. A possible two-pronged route (Hall, 2014: 1234) would be to reflate southern European economies over the short term by augmenting the money supply available to spending and investing and reducing taxes. At the same time, it should be coupled with a long-term development strategy, backed by substantial transfers from the north, aimed at advance the productive sectors on which the south can be able to compete.

A way out could be to promote Eurozone-wide spending that do not entails national governments' action. Spending "flexibility" given to Member States under financial stress are interpreted by electorates in more stable countries as a zero-sum "defeat" of their own government and hamper the ability of spending Member States to reduce their deficit. On the contrary, it would be easier to brand as positive-sum the creation of Eurozone centralized "safety nets" that would protect groups under stress because of the financial crisis in all countries, such as recently unemployed young citizens, older workers unable to find jobs and close to their pensions, re-training individuals, European internal migrants and refugees. Additional measures could be envisioned by expanding European investment spending and tax cuts for expanding research spending and employment in depressed regions and among pressured groups (such as refugees).

The characteristically long-term decision making process of the European juggernaut seem to be starting to understand such structural needs for a successful relaunch of the Eurozone economy. However, until now it has only amounted to little more than talks and symbolic plans. The much-trumpeted Juncker plan, that aimed to invest over 300 bln Euro and it should now be expanded (EC, 2016), and the strengthening of the

European Investment Bank are certainly positive, albeit slow, signs. Nevertheless, the “fresh money” put on the table by these projects appear to be rather limited, hampering their ability to kick start systemic growth.

Recently, Bundesbank President Jens Weidmann and Bank of France Chief Francois Villeroy de Galhau co-signed an article published simultaneously on French and German newspapers signaling their institutional interest in the creation of a “Euro Finance Minister”. The conceptual overcoming of the monetarist economic thinking that had molded the original architecture of the Eurozone has been signaled by their declaration that "although monetary policy has done a lot for the euro zone economy, it can't create sustainable economic growth" (Villeroy de Galhau & Weidmann, 2016).

One of the main points mentioned is the need for a "financing and investment union". As they recognize, a central challenge in the Eurozone currently is the lack of proper investment financing, a market failure consequential to the lowered trust among member states, caution given by the crisis and lack of proper incentives. According to them “equity financing is the better way to share risks and opportunities, as well as to support innovation” (Villeroy de Galhau & Weidmann, 2016), and as such they deem it as a way to kick start investment in the Eurozone again, together with a Capital Markets Union (CMU).

Nevertheless, the uncertain environment created by the Brexit referendum and the increasing contestation wagered by populist parties against incumbent governments in France and Germany appear to be interpreted by many Member States as a call to stall further European integration and any possible “Euro ministry”, underlying national competencies. Recent declarations such as the Bratislava Declaration (European Council 2016b) are intentionally avoiding to signal strong common action against the crisis. This appears to be an ineffectual strategy that simply delays decision-making, probably waiting for German and French elections to pass in 2017.

The Italian Position Paper

The Italian government has recently published its own position paper on how it foresees a possible future for coordinated growth in the Eurozone. Consistently with a “southern” understanding of the economy, it envisages the need for more convergence between structural reforms and a stronger domestic demand, in order not to lose permanently potential growth due to lower output capabilities. In order to do so, more

focus should be given to flexibility and growth-oriented fiscal policies, a clear call for revision to austerity measures but under a more neutral denomination.

Given that the weaker economies in the Eurozone have allowed stronger economies like Germany to avoid appreciation, thus obtaining huge trade surpluses, Italy also calls for additional attention also to this type of imbalances (MEF, 2016: 3), something that it is currently overlooked, as the focus is on trade deficits.

Issuance of common project bonds, the strengthening of the newly founded European Fund for Strategic Investment, additional synergy to national promotional banks and national budgets, and a European Monetary Fund are all financial instruments and possibilities defined by Italy as in the realm of possibilities for a new "Euro Finance Minister", with many of such measures possible without a further treaty revision, deemed risky by many in the EU.

As a southern economy with an economic governance hit hard by a lack of room for increasing local consumption by expansive social programs (such as measures for the unemployed) as it would go against its current drive to reduce public debt, Italy is also advocating for Euro-wide macroeconomic stabilization mechanism to mitigate cyclical unemployment and its consequences. Specifically, it is suggesting an unemployment insurance scheme that would "consolidate medium-term growth by smoothing the adjustment needed in presence of adverse shocks and limiting negative impact on other countries." (MEF, 2016: 6).

Conclusion

The interpretation of the Euro crisis is not a neutral topic. Different interpretations of its causes entail different recipes for overcoming it. In this short piece, I have tried to give an account of two possible interpretations and of some ongoing proposals for fixing the governance of the Eurozone, which is clearly not working as intended (even if these results were foreseeable in hindsight).

It appears that only through additional centralization of economic and financial powers and Europeanization of expansive measures it will be possible to avoid the trap of zero-sum interpretations in northern European electorates. I reckon possible a compromise between different readings of the current structural faults in

order to find a new settlement that may produce stability and growth at the same time. Nevertheless, it is difficult to believe it possible unless bold decisions are taken – especially by "northern economies" – and a real supranational institution is created with budgetary depth and some degree of democratic representativeness.

Any institutional answer will not be a stable solution if it will fail to consider the varieties of capitalism existing in both northern and southern European countries. Simple suggestions of enforcing structural changes for making southern markets more similar to the northerners ignores that changing the economic outlook of the former would be a very slow process that has to be supported vigorously and expansively. Any compromise would entail almost certainly structural reforms while providing instruments for sizable investments in the south. In this way, current budgetary rules would be enforced while the economy would be stimulated to grow again, thus reducing the ratio debt-GDP.

Limited investment plans and simple monetary solutions such as those enacted by the European Central Bank seem to have reached their maximum capability and legitimation, and need to be coupled with additional convergence by Member States, a degree of common fiscal capacity and a Eurozone treasury in order to unleash measures that may raise the consumption depressed by the crisis. On this regards, theoretical proposal such as the rumored "helicopter money" would be much more effective if under guidance from a deputed Euro-area policy outlet such as a "Euro finance minister", institution advocated by France and Germany.

Autonomous fiscal capacity, ability to raise project bonds after authorization from the European Council or ECOFIN, or financing from ECB could all be favorable outlet for sustaining such body, as the goal is to detach it from Member States in order to depersonalize the measures, insulating them from national rationales and propping the image of the EU to local electorates.

Possible positive-sum operations would be investment plans and the creation of Eurozone centralized "safety nets" directed at groups put under financial stress by the crisis, such as recently unemployed young citizens, older workers unable to find jobs and close to their pensions, individuals to be re-trained, European internal

migrants and refugees. Additional measures could be expanding European investment spending and tax cuts for expanding research spending and employment in depressed regions and among pressured groups (such as refugees). A significant boon created by such centralized measures would be that disadvantaged groups would perceive the European Union as directly involved in their welfare, raising its profile among those constituencies that are currently trending towards Eurosceptic positions, strengthening the long-term ability of the Union to press forward and thrive as an institution.

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